AFM 291
Intermediate Financial Accounting I
University of Waterloo
Exam 2
November 7, 2008
K. Kelly (Sections 001-003) and R. Ducharme (Section 004)

Name: ______________________________________

UWDIR/Quest ID: _____________________________

Student ID: __________________________________

Section (please circle): Section 1: 8:30-10:00 Section 2: 10:00-11:20

Section 3: 1:00-2:20 Section 4: 2:30-3:50

Instructions:

1. This is a closed note, closed book examination. You may use pen/pencil and a calculator during the examination.
2. The examination includes 19 pages (including the cover page) - please ensure that all the pages have been included. If any pages are detached, they must be re-attached to the examination before the exam is handed in, to receive marks for work shown on these pages.
3. Show all your work and calculations. We cannot give partial credit if we cannot see the work you have done. No partial credit is given for multiple choice questions.
4. Unless otherwise stated, assume that the fiscal year end is December 31.
5. For parts C thru G of the examination, round your answers to the nearest dollar.
6. When you have completed the exam, please leave your answers on your desk with the title page facing upwards.
7. You have 2 hours to complete the exam – please allocate your time wisely.
8. Good Luck!

Grading

Examination Breakdown:

Part		**Your Points**	**Total Points**
A	**Multiple Choice**		**/10**
B	**Multiple Choice**		**/10**
C	**Retail Inventory Method**		**/15**
D	**Investments**		**/21**
E	**Investments**		**/20**
F	**Exchange of Assets**		**/14**
G	**Acquisition Costs**		**/10**
Total			**/100**

Part A: Multiple Choice (1 Point Each – No Partial Credit Will be Awarded)
Please circle your choice (a, b, c, or d).

1. When using a perpetual inventory system,
   a. no Purchases account is used.
   b. a Cost of Goods Sold account is used.
   c. two entries are required to record a sale.
   d. all of these.

2. All investments in debt securities are measured at fair value *except*
   a. loans and receivables and held-to-maturity investments.
   b. loans and receivables and available-for-sale investments.
   c. loans and receivables and held-for-trading investments.
   d. held-for-trading and held-to-maturity investments.

3. Which of these is *not* a major characteristic of a property, plant, and equipment asset?
   a. Possesses physical substance
   b. Acquired for use in operations
   c. Yields services over a number of years
   d. All of these are major characteristics of a property, plant, and equipment asset.

4. Goods on consignment are
   a. included in the consignee's inventory.
   b. recorded in a Consignment Out account which is an inventory account.
   c. recorded in a Consignment In account which is an inventory account.
   d. all of these

5. Comprehensive income is included as part of
   a. retained earnings.
   b. shareholders' equity.
   c. net income.
   d. unearned revenue.

6. The cost of land does *not* include
   a. costs of grading, filling, draining, and clearing.
   b. costs of removing old buildings.
   c. costs of improvements with limited lives.
   d. special assessments.

7. On June 15, 2008, Stilley Corporation accepted delivery of merchandise which it purchased on account. As of June 30, Stilley had not recorded the transaction or included the merchandise in its inventory. The effect of this on its balance sheet for June 30, 2008 would be
   a. assets and shareholders' equity were overstated but liabilities were not affected.
   b. shareholders' equity was the only item affected by the omission.
   c. assets, liabilities, and shareholders' equity were understated.
   d. none of these.

8. For an equity investment, where there is no significant influence, the investment should be accounted for using the
   a. cost method.
   b. fair value method.
   c. fair value method if there is a quoted price; otherwise the cost method.
   d. equity method.

9. Sloan Company's investment portfolio (Held for Trading), which is appropriately included in current assets is as follows:

	December 31, 2007		
	Cost	Fair Value	Unrealized Gain (Loss)
Arlington Corp.	260,000	210,000	$(50,000)
Downs, Ltd.	245,000	265,000	20,000
	$505,000	$475,000	$(30,000)

   Ignoring income taxes, what amount should be reported as a charge against income in Sloan's 2007 income statement if 2007 is Sloan's first year of operation and it applies fair value reporting?
   a. $0.
   b. $20,000.
   c. $30,000.
   d. $50,000

10. When a plant asset is acquired by the issuance of common shares, the cost of the plant asset is properly measured by the
   a. market value of the shares.
   b. no par value of the shares.
   c. stated value of the shares.
   d. book value of the shares.

Part B: Multiple Choice (2 Points Each – No Partial Credit Will be Awarded)
Please circle your choice (a, b, c, or d).

Use the following information for questions 11 and 12.

Dexter, Ltd. is a calendar-year corporation. Its financial statements for the years 2007 and 2006 contained errors as follows:

	2007	2006
Ending inventory	$4,000 overstated	$7,000 overstated
Amortization expense	$2,000 understated	$8,000 overstated

11. Assume that the proper correcting entries were made at December 31, 2006. By how much will 2007 income before taxes be overstated or understated?
    a. $2,000 understated
    b. $2,000 overstated
    c. $4,000 overstated
    d. $6,000 overstated

12. Assume that *no* correcting entries were made at December 31, 2006. *Ignoring income taxes,* by how much will retained earnings at December 31, 2007 be overstated or understated?
    a. $2,000 understated
    b. $6,000 overstated
    c. $6,000 understated
    d. $9,000 understated

13. On August 1, 2006, Camby Company acquired $60,000 face value 10% bonds of Hanson Corporation at 104 plus accrued interest. The bonds were dated May 1, 2006, and mature on April 30, 2011, with interest payable each October 31 and April 30. The bonds will be held to maturity. What entry should Camby make to record the purchase of the bonds on August 1, 2006?

		Debit	Credit
a.	Investment in Bonds	62,400	
	Interest Receivable	1,500	
	Cash		63,900
b.	Investment in Bonds	63,900	
	Cash		63,900
c.	Investment in Bonds	63,900	
	Interest Revenue		1,500
	Cash		62,400
d.	Investment in Bonds	60,000	
	Premium on Bonds	3,900	
	Cash		63,900

14. On March 1, 2006, Gregg Company purchased land for an office site by paying \$270,000 cash. Gregg began construction on the office building on March 1. The office was completed and ready for occupancy on July 1. The following expenditures were incurred for construction:

Date	Expenditures
March 1, 2006	\$450,000
April 1, 2006	252,000
May 1, 2006	450,000
June 1, 2006	720,000

The weighted-average accumulated expenditures on the construction project during 2006 were

a. \$258,000.
b. \$1,467,000.
c. \$156,000.
d. \$348,000.

15. During 2006, Allen Corporation constructed assets costing \$500,000. The weighted-average accumulated expenditures on these assets during 2006 was \$300,000. To help pay for construction, \$220,000 was borrowed at 10% on January 1, 2006, and funds not needed for construction were temporarily invested in short-term securities, yielding \$4,500 in interest revenue. Other than the construction funds borrowed, the only other debt outstanding during the year was a \$250,000, 10-year, 9% note payable dated January 1, 2000. What is the amount of interest that should be capitalized by Allen during 2006?

a. \$30,000.
b. \$15,000.
c. \$29,200.
d. \$47,200.

Part C: Retail Inventory Method (15 points)

When you undertook the preparation of the financial statements for Barriere Company at January 31, 2007, the following data were available:

	At Cost	At Retail
Inventory, February 1, 2006	$72,800	$ 98,500
Markdowns		45,000
Markups		73,000
Markdown cancellations		20,000
Markup cancellations		10,000
Purchases	219,500	294,000
Sales		345,000
Purchases returns and allowances	4,300	5,500
Sales returns and allowances		10,000

Required

Calculate the ending inventory at cost as of January 31, 2007, using the retail inventory method that approximates lower of average cost and market. Your solution should be in good form with amounts clearly labelled.

Use this space to show your work

Part D – Investments (21 Points)

Lennier Corp. acquired a 30% interest in Marcus Co. on January 1, 2008, for $600,000. At that time, Marcus had 1.5 million of its no par common shares issued and outstanding as well as a net book value of $550,000. $25,000 of the excess in the purchase cost over Lennier's share of Marcus's net book value is attributable to goodwill, which is not amortizable. The remaining $25,000 of the excess in the purchase cost over Lennier's share of Marcus's net book value is deemed to be unrecorded intangible assets with a 10-year life. During 2008, Marcus paid cash dividends of $300,000. Marcus's net income for 2008 was $480,000, comprising of $400,000 (net of tax) from continued operations, $100,000 (net of tax) from discontinued operations, and $20,000 (net of tax) from an extraordinary loss. The investment in Marcus had a fair value of $550,000 at December 31, 2008.

Required:

a) Assume that Lennier has significant influence over the operations of Marcus. What should be the balance in Lennier's investment account at the end of 2008?

Use this space to show your work

b) Assume that Lennier has significant influence over the operations of Marcus. Prepare the relevant journal entries related to Lennier's investment in Marcus for 2008.

Journal Entries:

Date	Account Name	Debit	Credit

c) Assume that Lennier does not have significant influence over the operations of Marcus and that Lennier purchase the shares of Marcus with the intention of selling in the near future. Prepare the relevant journal entries related to Lennier's investment in Marcus for 2008.

Journal Entries:

Date	Account Name	Debit	Credit

Part E – Investments (20 points)

On January 1, 2008, Sheridan Inc. purchased bonds issued by Shadows Inc. with a face value of $100,000 with a three-year term and paying annual interest of $8,000 each year on December 31. The current market interest rate is 5%. Sheridan has <u>no intention of holding the bonds to maturity</u> and <u>no intention to sell the bonds in the near future</u>. The fair value of the bonds is $110,000 on December 31, 2008.

Required

a) Calculate the purchase price that Sheridan paid for the bonds. *Use the space below to show your work.*

b) Prepare the premium amortization schedule with respect to the bonds for Sheridan. *Use the space below to show your work.*

c) Prepare all of the relevant journal entries for 2008 with respect to Sheridan's investment in the bonds.

Journal Entries:

Date	Account Name	Debit	Credit

Part F – Exchange of Assets (14 points)

On December 31, 2007, Zanad Co. exchanged Building 24 which has an appraised value of $1,600,000, a cost of $2,530,000, and accumulated amortization of $1,200,000 for Building M belonging to Mike Co. Building M has an appraised value of $1,510,000, a cost of $3,010,000, and accumulated amortization of $1,584,000. The correct amount of cash was also paid. Assume amortization has already been updated.

Required

Prepare the journal entries on both companies' books assuming the buildings are <u>similar</u> assets and there would be <u>no significant change in the expected future cash flows</u> of both companies after the exchange. *Use the space below to show your work and present the journal entries on the following page.*

Journal Entries for Zanad:

Date	Account Name	Debit	Credit

Journal Entries for Mike:

Date	Account Name	Debit	Credit

Part G – Acquisition Costs (10 points)

On 2 Jan 2007, Delenn Manufacturing Co. was incorporated. However, Delenn could not begin manufacturing activities until 1 Aug 07 because the new factory building was not completed until that date.

Additional information:

1. To acquire the land (which had an old building on it) on 31 Jan 2007, Delenn paid $100,000 cash and 1,000 of its common shares which are not traded and have no determinable market value. The fair value of the land on that date was $300,000.
2. On 5 Jan 2007, Delenn paid a special tax assessment for streets amounting to $5,400.
3. The old building was removed immediately after purchase to make way for the construction of the new factory building. Delenn paid Kosh Demolition Co. $5,000, but also received $1,000 from the sale of salvaged material.
4. On 4 Jan 2007, Delenn paid legal fees covering the following:

Cost of organization	$1,000
Examination of title covering purchase of land	1,500
Registration of land title with Land Registry Office	500
Legal work in connection with the factory building construction	3,000
	$6,000

5. For the construction of the new factory building, Delenn paid a partial payment of $150,000 to the contractor on 1 May 2007. The final payment of $200,000 was paid on 1 Aug 2007 upon the completion of the construction.
6. Delenn paid $10,000 for the construction of a parking lot on the land on 28 Feb 2007.
7. Delenn paid fire insurance premium of $6,000 on 1 May 2007 for its new factory building. The fire insurance premium covered premiums for a three-year term beginning May 1, 2007.
8. Because of the rising land costs, the president was sure that the fair value of the land as at 31 Dec 2007 was at least $100,000 more than what it cost the company.
9. Delenn received a government grant of $50,000 to build the new factory building and used the cost reduction method to account for the grant.
10. On 7 Dec 2007, Delenn spent $15,000 repairing the roof of the factory building when a winter storm damaged part of the roof.

Required

Determine the proper balances as of 31 Dec 2007 for a separate land account and a separate building account. Use separate T accounts (one for land and one for building), labelling all the relevant amounts, disclosing all calculations, and clearly identifying the debit and credit columns in the T accounts.

Use this space to show your work

AFM 291
EXAM 2 SOLUTION SET
Fall 2008

Part A: Multiple Choice (1 point each – No partial credit)

1. d
2. a
3. d
4. b
5. b
6. c
7. d
8. c
9. c
10. a

Part B: Multiple Choice (2 points each – No partial credit)

11. d $4,000 + $2,000 = $6,000 overstatement.
COGS = Beginning inventory + Purchases – Ending inventory
In 2007, ending inventory is overstated by $4,000, COGS is understated by $4,000, and income is overstated by $$4,000. Amortization expense is understated by $2,000, income is overstated by $2,000. Total effect on 2007 income = $6,000 overstatement

12. a $1,000 + $1,000 = $2,000 understatement.
In 2006, ending inventory is overstated by $7,000, COGS is understated by $7,000, and income and retained earnings are overstated by $7,000. Amortization expense is overstated by $8,000, income and retained earnings are understated by $8,000. Net effect on income and retained earnings in 2006 = $1,000 understatement.
In 2007, beginning inventory is overstated by $7,000 and ending inventory is overstated by $4,000, COGS is overstated by $3,000, and income and retained earnings are understated by $3,000. Amortization expense is understated by $2,000, income and retained earnings is overstated by $2,000. Net effect on income and retained earnings in 2007 = $1,000 understatement. Total effect on retained earnings as at 31 Dec 2007 = $2,000 understatement.

13. a Dr. Investment in Bonds: $60,000 × 1.04 = $62,400
Dr. Interest Revenue: $60,000 × .05 × 3/6 = $1,500
Cr. Cash: $62,400 + $1,500 = $63,900.

14. d ($450,000 × 4/12) + ($252,000 × 3/12) + ($450,000 × 2/12) + ($720,000 × 1/12) = $348,000.

15. c ($220,000 × .1) + ($80,000 × .09) = $29,200.

Part C: Retail Inventory Method (15 points)

	At Cost		At Retail		Points
Beginning inventory, 2/1/06		$72,800		$98,500	2
Purchases	219,500		294,000		2
Less Purchase returns	4,300	215,200	5,500	288,500	2
Totals		288,000		387,000	
Add net markups (i.e., 73000 – 10,000)				63,000	2
				450,000	
Cost to Retail Ratio = $288,000 ÷ $450,000 = 64%					1
Deduct net markdowns (i.e., 45,000 – 20,000)				25,000	2
Sales price of goods available				425,000	
Less net sales (i.e., sales less sales returns = 345,000 – 10,000)				335,000	2
Ending inventory, 1/31/07 at retail				90,000	1
Ending inventory at cost: $90,000 × 64% = $57,600		57,600			1 (calc)

Part D – Investments (21 Points)

(a) 4 points

Cost	$600,000	1 point
Share of net income (.3 × $480,000)	144,000	1 point
Share of dividends (.3 × $300,000)	(90,000)	1 point
Amortization of unrecorded intangibles ($25,000 / 10)	(2,500)	1 point
Balance in investment account	$651,500	

b) 10 points

Date	Account Name	Debit	Credit	Points
1 Jan 08	Investment in Marcus	600,000		0.5 for name. 0.5 for amount
	Cash		600,000	0.5 for name. 0.5 for amount
2008	Investment in Marcus	144,000		0.5 for name. 0.5 for amount
	Extraordinary Investment Loss	6,000		0.5 for name. 0.5 for amount
	Investment Income		120,000	0.5 for name. 0.5 for amount
	Investment Income from discontinued operations		30,000	0.5 for name. 0.5 for amount
2008	Cash	90,000		0.5 for name. 0.5 for amount
	Investment in Marcus		90,000	0.5 for name. 0.5 for amount
31 Dec 08	Investment Income	2,500		0.5 for name. 0.5 for amount
	Investment in Marcus		2,500	0.5 for name. 0.5 for amount

Less 1 point for erroneous additional entry (e.g., Goodwill in the first journal entry)

Part D – Investments (21 Points)

c) 7 points

Date	Account Name	Debit	Credit	Points
1 Jan 08	Investment in Marcus (HFT) (note: student has to identify that the investment is classified as HFT to earn full points for the account name)	600,000		1.5 for name. 0.5 for amount
	Cash		600,000	0.5 for name. 0.5 for amount
2008	Cash	90,000		0.5 for name. 0.5 for amount
	Investment Income or Dividend Revenue		90,000	0.5 for name. 0.5 for amount
31 Dec 08	Investment Income/Loss	50,000		0.5 for name. 0.5 for amount
	Investment in Marcus (HFT)		50,000	0.5 for name. 0.5 for amount

Less 1 point for erroneous additional entry (e.g., amortization of intangibles)

Part E – Investments (20 points)

a) Full 4 points if the student presents the correct present value of the note

Present value of the principal:	
$100,000(PVF*$_{3,5\%}$) = {0.86384}	$86,384
Present value of the coupon:	
$8,000(PVF*OA$_{3,5\%}$) = {2.72325}	21,786
Present value of the note	108,170

Partial credit is given for the following:
- For the PV of the principal:
  - ⇨ 0.5 pt for the principal amount, 0.5 point for correct n =3, 0.5 point for correct i = 5%, or 1 pt for the correct PV factor for the single sum
- For the PV of the coupon:

=> 0.5 pt for the coupon amount, 0.5 point for the correct n = 3, 0.5 point for the correct i = 5%, or 1 pt for the correct PV factor for the ordinary annuity

b) 8 points

Sheridan Inc.
Premium Amortization Schedule
8% Note Discounted at 5%

Date of Issue	Cash Received	Interest	Premium Amortization	Carrying Value
				$108,170
End of Year 1	$ 8,000	$ 5,409	$(2,591)	105,579
End of Year 2	8,000	5,279	(2,721)	102,858
End of Year 3	8,000	5,142	(2,858)	100,000
	$24,000	$15,830	$(8,170)	
	0.5 point for correct cash in each period. Total = 1.5 points	1 point for correct calc. of interest based on 5% in each period . Total = 3 points	0.5 point each for correct calc. of premium amortization in each period. Total = 1.5 points	0.5 point each for correct calc. of carrying value in each period, including beginning carrying value. Total = 2 points

Part E – Investments (20 points)

c) 8 points

Date	Account Name	Debit	Credit	Points
1 Jan 08	Investment in Shadow Bonds (AFS) (note: student has to identify that the investment is classified as AFS to earn full points for the account name)	108,170		1.5 for name. 0.5 for amount
	Cash		108,170	0.5 for name. 0.5 for amount
31 Dec 08	Cash	8,000		0.5 for name. 0.5 for amount
	Investment in Shadow Bonds (AFS)		2,591	0.5 for name. 0.5 for amount
	Interest Income		5,409	0.5 for name. 0.5 for amount
31 Dec 08	Investment in Shadow Bonds (AFS)	4,421		0.5 for name. 0.5 for amount
	Holding Gain on Shadow Bonds (OCI) (note: student has to identify that the holding gain is OCI to earn full points for the account name)		4,421	0.5 for name. 0.5 for amount

Part F – Exchange of Assets (14 points)

Zanad Co.:

Cost	$2,530,000
Accumulated amortization	1,200,000
Book value	1,330,000
Fair value	1,600,000
Gain	$ 270,000

No gain is recognized because the exchange lacks commercial substance.

Date	Account Name	Debit	Credit	Points
31 Dec 07	Accumulated Amortization	1,200,000		1 for name. 1 for amount
	Building M	1,240,000		1 for name. 1 for amount
	Cash	90,000		0.5 for name. 0.5 for amount
	Building 24		2,530,000	1 for name. 1 for amount

Less 1 point if gain is recognized.
Less 2 points if Zanad's JE are put under Mike's JE

Mike Co.:

Cost	$3,010,000
Accumulated Amortization	1,584,000
Book value	1,426,000
Fair value	1,510,000
Gain	$ 84,000

Date	Account Name	Debit	Credit	Points
31 Dec 07	Accumulated Amortization	1,584,000		1 for name. 1 for amount
	Building 24	1,516,000		1 for name. 1 for amount
	Cash		90,000	0.5 for name. 0.5 for amount
	Building M		3,010,000	1 for name. 1 for amount

Less 1 point if gain is recognized.
Less 2 points if Mike' JE are put under Zanad's JE.

Part G – Acquisition Costs (10 points)

Less 1 pt if the dr or cr columns in the T accounts are incorrectly labelled

Land

Dr		Cr
Land and old building (FV)	300,000	1 point
Special assessment	5,400	1 point
Removal of old building ($5,000 – $1,000)	4,000	1 pt for removal cost, 1 pt for salvage
Legal fees ($1,500 + $500)	2,000	0.5 pt for title exam, 0.5 for title registration
Balance	311,400	

Less 1 point for every additional amount that should be excluded

Building

Dr		Cr		
Legal Fees	3,000	1 point		
Partial payment	150,000	1 point		
Insurance (3 months) ($6,000x3/36)	500	1 point		
Final payment	200,000	1 point		
		Government grant	50,000	1 pt
Balance	303,500			

Less 1 point for every additional amount that should be excluded